TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Update on Federal Legislation ITEM NUMBER: 6b

ATTACHMENT(S): 2

ACTION: X MEETING DATE: July 11, 2002

INFORMATION: ___ PRESENTER: Ed Derman

SUMMARY

Beside the recent Congressional activity in response to the Enron debacle, agency regulatory efforts are beginning to be proposed. The legislative and regulatory measures that are now being evaluated are summarized below and discussed in greater detail in the attached report.

INVESTOR PROTECTION AND ACCOUNTING OVERSIGHT LEGISLATION

Senate Legislation

On June 18, the Senate Banking, Housing and Urban Affairs Committee with an extensive bipartisan vote of 17-4 (with 6 Republicans voting in favor), adopted a modified legislative package on investor protection and accounting oversight legislation proposed by Chairman Paul Sarbanes (D-Md.). The legislation now moves to the full Senate for deliberation, where Senate Majority Leader Tom Daschle (D-S.D.) has indicated that he would like to package together the investor protection and accounting oversight legislation along with pension security legislation and securities fraud litigation changes into one omnibus "Enron" measure. Congress may possibly look at the proposal before it leaves at the beginning of August for the summer recess, but the Senate Floor agenda is occupied with other important priorities.

Key features of the Sarbanes proposal, according to the official description, that address concerns raised by the Board through its Investment Committee Subcommittee on Corporate Governance include:

- A new accounting oversight board, with at least three of its five members being from outside the accounting profession
- Prohibitions on specific non-audit activities, subject to individual exemption by the new Board
- A one-year cooling-off period before a firm could hire a person who conducted an audit as CEO or CFO
- Calling for a rotation of audit firm partners providing audit services to the same client after five consecutive years, and requiring the General Accounting Office to study the merits of requiring audit firm rotation

- Imposing on the audit committee the responsibility to appoint and set compensation of auditors

Key changes from Chairman Sarbanes's earlier proposal include: a limited loosening of the "bright-line" between audit and proscribed "non-audit" services by permitting the new accounting oversight board to grant exemptions from the list of proscribed non-audit services on a case-by-case basis; and the dropping of a requirement that the Securities and Exchange Commission (SEC) make recommendations regarding the appropriate financial accounting treatment of stock options.

House Legislation

On April 24, the full House of Representatives passed the investor protection and accounting reform legislation known as the "Corporate and Auditing Accountability, Responsibility, and Transparency Act" (H.R. 3763), which was drafted by House Financial Services Committee Chairman Michael Oxley (R-Ohio). The legislation would make a number of changes in the regulation of the accounting profession as well as providing for enhanced corporate disclosure to investors. The Sarbanes proposal, however, more closely addresses the concerns previously raised by the Corporate Governance Subcommittee.

SEC REGULATORY EFFORTS

In its ongoing effort to reinsert itself into the investor protection and accounting oversight debate, the SEC was expected to announce on June 20 a new "Public Accountability Board". Operating under SEC supervision, the board would be given the mission to set or oversee the establishment of professional audit, quality control, and ethics standards, according to a letter from SEC Chairman Harvey Pitt to President Bush. The new board will have the power to undertake reviews of accounting firms and to discipline accounting firms and individuals, but would not have formal subpoena power.

These SEC measures follow other new rules announced by the SEC on June 12 that require a company's principal executive officer and principal financial officer to certify the contents of the company's quarterly and annual financial reports. In addition, the June 12 SEC rules would require companies to maintain procedures to provide "reasonable assurance" that the company is able to collect, process, and disclose all information that is required to be disclosed in the company's reports. Finally, the SEC required prompter disclosure of extraordinary corporate events.

CORPORATE GOVERNANCE REFORMS BY LISTING EXCHANGES

Proposed NYSE Guidelines

On June 6, the New York Stock Exchange's Corporate Accountability and Listing Standards Committee proposed new standards and modifications in corporate governance and disclosure practices of NYSE-listed companies. The NYSE Board of Directors must endorse these proposed changes. Among the proposals that reflect Board concerns are:

- A requirement that audit, nominating and compensation committees consist entirely of independent directors
- Granting the audit committee the authority to hire and fire auditors, and approve any significant non-audit work by their auditors
- Requiring that listed companies adopt and publish corporate governance guidelines and a code of conduct and ethics

New NASDAQ Rules

On June 5, NASDAQ announced that its Board of Directors has approved a series of new corporate governance rules which, following a comment period, are likely to be put into practice for NASDAQ companies later this summer. These rules concern:

- Stock option plans
- Independent directors
- Related party transactions
- Explicit prohibition on misrepresenting information to NASDAQ
- Requirement to disclose audit opinions with going concern qualifications
- Disclosure of material information

NASDAQ also announced that its Listing and Hearing Review Council will review the following potential additional corporate governance reforms at the next Council meeting in San Francisco on June 26-28:

- A majority of independent directors on corporate boards
- Compensation committees composed solely of independent directors
- A cooling-off period during which former auditors would be precluded from serving on corporate audit committees
- Expanding the scope of audit committee authority
- Strengthening continuing education for directors
- Increasing the use of corporate codes of conduct and compliance methods to support them
- Mandate non-U.S. companies to disclose if they have received waivers of corporate governance standards through a new SEC disclosure requirement

SECURITIES FRAUD LITIGATION LEGISLATION

The Senate Judiciary Committee, on May 6, reported out S. 2010, the "Corporate and Criminal Fraud Accountability Act of 2002", drafted by Chairman Patrick Leahy (D-Vt.) to the full Senate. The legislation would supplement the current patchwork of technical securities law violations with a more general and less technical provision, comparable to bank fraud statutes.

This securities fraud litigation legislation is expected to be packaged together with the investor protection and accounting oversight legislation reported out of the Senate Banking Committee and some version of pension security legislation into a single omnibus "Enron" package of legislation.

PENSION SECURITY LEGISLATION

House Legislation

The House of Representatives on April 11 passed the first piece of legislation reacting to the Enron fiasco by adopting a pension security package, H.R. 3762 (the "Pension Security Act of 2002"). This legislation melded together competing versions of the legislation produced by the House Ways and Means Committee, chaired by Rep. Bill Thomas (R-Bakersfield), and the Education and Workforce Committee, chaired by Rep. John Boehner (R-Ohio).

The provisions of the House pension security legislation, according to the official description, that reflect concerns raised by the Board include:

- A 30-day notice if a blackout on transactions would last more than 3 calendar days
- Authority to immediately diversify employee contributions to pension plans
- Authority to diversify employer contributions three-years after the contribution is made, plus a five-year transition rule for allowable diversification of employer securities currently held in individual accounts

CalSTRS is continuing to coordinate with the informal working group of State and local government organizations, with CalPERS, and with the Governor's office in Washington in working with Congressional staff in the Senate – as the Finance Committee staff works to put together counterpart legislation—to clarify several technical aspects of these provisions.

Senate Legislation

As the Senate Health, Education, Labor, and Pensions Committee has reported out its pension security package, the Senate continues to expect action by the Senate Finance Committee, which has jurisdiction over the tax rules governing pension plans and shares jurisdiction over ERISA with the Senate Labor Committee.

Senate Labor Committee package

The Senate Health, Education, Labor, and Pensions Committee, chaired by Sen. Edward Kennedy (D-Mass.), adopted a controversial version of pension security legislation (S. 1992) on a sharply divided party line vote. The Senate Labor Committee measure reflects a number of Board concerns, including:

- Permiting continued use of employer stock matches and of company stock as an investment option, but not both
- Prohibiting the required investment of plan assets in employer stock

- Requiring that a 30-day written notice would have to be provided in advance of any "lock-down", which could not continue for an unreasonable period of time

The proposal also:

- Allows plan sponsors to designate independent investment advisors for participants, in accordance with certain guidelines
- Requires pension benefit statements be issued on a quarterly basis
- Allows the plan fiduciary to be sued under ERISA for breach of fiduciary duty
- Requires the fiduciary of an individual account plan having more than 100 participants to have to provide adequate insurance coverage for failure to comply with fiduciary duties. Liability for breach of fiduciary duty would be extended to other persons who participate in or conceal such breach
- Requires that insider stock transactions would have to be disclosed promptly in electronic form
- Requires that a single employer plan which an individual account plan covering more than 100 participants must be governed by a board of trustees, equally divided between those representing the employer and participant interests. In the case of collectively-bargained plans, the trustees representing employee interests would be determined by election in which all participants may participate

Senate Finance Committee proposal

The Senate Finance package is expected to cover many of the same areas as the House Ways and Means measure that was merged into H.R. 3762 before it passed the House. The Finance Committee's package is still under development and is expected to be taken up by the Committee in July.

ELK HILLS COMPENSATION

CalSTRS continues the yearlong effort to pursue the necessary Congressional appropriation of the fifth $36 million installment of Elk Hills compensation due for FY 2003. A request for the Elk Hills appropriation from all 52 California House Members having gone into the House appropriations leadership, the next step in the process is Committee mark-up of the Interior Appropriations legislation for FY 2003 by the House Interior Appropriations Subcommittee, chaired by Rep. Joe Skeen (R-N.M.). That mark-up is not expected until July.

CalSTRS' Washington counsel continues to work with Rep. Thomas and his staff to follow up on the Elk Hills appropriations request. On the Senate side, Sen. Dianne Feinstein (D-Ca.) sits on the Senate Interior Appropriations Subcommittee, which will consider the Elk Hills issue.

MEDICARE PRESCRIPTION DRUG LEGISLATION

On June 17, disregarding the ballooning Federal budget deficit in this election year, Congressional Republicans and Democrats each proposed competing versions of a new prescription drug benefit. The House Republicans' proposal would be provided through private insurance or managed care, and would pay 80 percent of the first $1,000 in drug costs after a

$250 deductible, followed by 50 percent of the next $1,000. The patient would pay all of the next $2,000 in drug costs. The program would pay all drug costs after a total of $3,800 in annual drug costs were paid out-of-pocket. This benefit would cost a premium of $34 per month. This program has a projected 10-year cost of $350 million. Under the Senate Democrats' proposal, the Medicare program would be changed to cover drugs, subject to a $10 co-pay for generic drugs and $40 for a brand-name drug, with an annual out-of-pocket limit of $4,000. This benefit would cost a premium of $25 per month. The Democratic proposal would cost a total of $500 million over six years and as much as $800 million over ten years.

SUMMARY OF FEDERAL LEGISLATION

Also attached is a summary of all federal legislation that contains provisions of interest to CalSTRS or its members, and their current status in Congress.

Mr. Derman will provide a verbal update at the meeting.

MEMORANDUM FOR
THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

Washington Monthly Report

Investor Protection and Accounting Oversight Legislation

Senate Legislation

Following negotiations into the night between Chairman Paul Sarbanes (D-Md.) and ranking Republican Sen. Mike Enzi (R-Wy.), the Senate Banking, Housing and Urban Affairs Committee on June 18, by a broad bipartisan vote of 17-4 (with 6 Republicans voting in favor), adopted a revised legislative package on investor protection and accounting oversight legislation proffered by Chairman Sarbanes. The final measure reflects only very modest concessions made by Chairman Sarbanes. The legislation now goes to the full Senate for consideration, where Senate Majority Leader Tom Daschle (D-S.D.) has indicated that he would like to package together the investor protection and accounting oversight legislation along with pension security legislation and securities fraud litigation changes into a single omnibus "Enron" measure.

In brief, Chairman Sarbanes's revised package establishes a stronger accounting oversight board than under the House legislation, seeks to promote the independence of outside auditors, and provides for reforms in corporate governance and financial disclosure. Key changes from Chairman Sarbanes's earlier proposal include: a limited loosening of the "bright-line" between audit and proscribed "non-audit" services by permitting the new accounting oversight board to grant exemptions from the list of proscribed non-audit services on a case-by-case basis; and the dropping of a requirement that the Securities and Exchange Commission make recommendations regarding the appropriate financial accounting treatment of stock options.

Key features of the Sarbanes proposal, according to the official description, are as follows:

New Accounting Oversight Board

- The legislation addresses the needs of investors to restore confidence in public company financial reporting and their accountants by setting up a strong private sector board to oversee the public company auditing profession. The bill establishes a Public Company Accounting Oversight Board, as a private regulatory organization.

- The Board, overseen by the SEC, would have authority solely relating to the work of accounting firms auditing public companies.

- Members of the new Board would be appointed by the SEC after consultation with the Department of the Treasury and the Federal Reserve Board and according to the legislation's description must be persons of integrity and reputation who have a demonstrated commitment to the interests of investors and the public. No more than two of its five members may have an accountancy background.

- The new Board would establish its own budget, subject to review of the budget by the SEC, and would be independently funded by public companies in a manner to be established by the Board and the SEC. Chairman Sarbanes dropped the original provision that would also have imposed fees on the regulated accounting firms as a funding source.

- The Board would have authority to establish or adopt auditing, quality control standards, and ethics rules to govern the conduct of audits for public companies. As part of the final compromise, the accounting profession would have input into the accounting standards-setting process. Auditors would be required to: (1) retain all audit work for seven years; (2) obtain second partner review of audit reports; and (3) express an opinion on certain internal controls of public companies.

- The legislation provides for regular inspections by the Board of the work of registered public accounting firms, including annual inspections for the largest accounting firms (initially, those that audit more than 100 public companies). The bill further grants the Board full authority to investigate any act that may violate the rules of the Board or the SEC, the securities laws (including the new statute), or professional accounting standards.

- The Board, subject to SEC review, would be authorized to impose a full range of disciplinary or remedial sanctions if it finds that a registered accounting firm, or its partners or employees have engaged in any act or practice that violates the Board's or SEC's rules, the securities laws

or professional standards. As part of the final compromise, these disciplinary proceedings would be confidential, subject to release by the SEC.

Independent Accounting Principles

- To better promote the effectiveness and independence of the accounting principles set by the Financial Accounting Standards Board ("FASB"), the legislation (1) authorizes the SEC to recognize such a standard setting body; (2) provides for the secure funding of such body; (3) requires that the body be governed by a board of trustees a majority of whom are not from the accounting profession; and (4) requires that the standard setting body set standards by majority rule.

Independence of Auditors

- To further promote the independence of public company auditors, the legislation restricts the non-auditing or consulting work that can be provided by auditors. The legislation prohibits providing public company audit clients with: (1) financial information systems design; (2) internal audit work; (3) expert opinions; and (4) appraisal services; (5) management functions or human resources; (6) investment banking and legal services; and (7) other services determined to be impermissible by the Board by regulation. In a change from the original version, the legislation permits the new Board to grant on a case-by-case, firm-and-client by firm-and-client basis, exemptions from the flat bar on specified non-audit services.

- All other non-audit work, including tax services, not specifically barred in the statute would be allowed if pre-approved by a public company's audit committee.

- The new Board is authorized to issue rules to implement these auditor independence provisions.

- The legislation would require the Congressional General Accounting Office (GAO) to study the merits of requiring audit firm rotation and report to Congress. The legislation does call for the rotation of accounting firm partners providing auditing services for the same issuer for more than 5 consecutive years.

- A one-year "cooling off" period would be required prior to a public company hiring as its Chief Executive Officer or Chief Financial Officer accounting firm personnel who had just conducted its audit.

Corporate Governance and Management Responsibility

- The legislation would require the audit committee of the company's board to be responsible for the appointment, compensation, and work of auditors and hear directly from the auditors on key matters. Audit committees would have to be independent from management; have procedures to address complaints regarding auditing issues; and have authority to retain counsel and advisors.

- The legislation includes the President's proposal requiring CEOs and CFOs to sign their company's audit report. Certifying that the financials fairly and accurately reflect the operations and financial condition of their company, the CEO and CFO would subsequently forfeit profits and bonuses realized in the 12 months before a material accounting restatement that occurs as a result of material noncompliance with securities laws.

- The legislation also strengthens the current sanction of barring securities law violators from serving as officers or directors. District courts would be permitted to impose bars if directors or officers demonstrate "unfitness," (rather than "substantial unfitness") to serve.

- The legislation makes it unlawful for any officer, director, or affiliated person to fraudulently influence, coerce, manipulate or mislead any accountant preparing an audit report.

Enhanced Financial Disclosures

- The legislation would further protect investors and promote transparent capital markets by enhancing a number of financial disclosures. It would require public companies to report loans to insiders on current reports filed with the SEC within seven calendar days or such other period determined by the SEC. Public companies would be required to present pro forma data in a manner not likely to mislead investors and clearly distinguished from GAAP financials. Public companies would be required to disclose off-balance sheet transactions and conflicts. Management and the company's auditor would be required to attest to the company's internal control procedures in the annual report. Insider trading would be required to be reported by the day following any transaction.

- The legislation omits a provision in Chairman Sarbanes's original proposal that would have directed the SEC to make recommendations to the accounting standard-setting board as to how different types of stock options should be treated for financial reporting.

Analyst Conflicts of Interest

- The legislation requires the SEC to enact rules, or to direct the self-regulatory organizations to enact rules, to prohibit certain conflicts that could compromise a security analyst's independence, and to disclose other potential conflicts in their research reports.

- Specifically, the legislation proposes to (1) protect analysts from retaliation for making unfavorable stock recommendations (a protection not in the new NASD/NYSE rules); (2) prevent investment banking staff from supervising research analysts or clearing their reports; (3) prohibit an analyst from distributing research reports on companies his or her firm is presently underwriting; (4) reinforce informational safeguards (so-called "Chinese Walls") between investment banking and research departments; and (5) address other issues as the SEC deems appropriate.

- The legislation would require an analyst to disclose (in public appearances and research reports): (1) any ownership of the company's stocks or bonds; (2) any compensation received from the company; (3) any client relationship with the company; (4) any compensation received by the analyst that is based on investment banking revenues received from the company; and (5) such other facts as the SEC deems appropriate.

Insider Trading During Blackout Periods

- Directors, officers, or beneficial owners would be prohibited from trading company stock during a "blackout" period when employees are prohibited from trading company stock held in individual retirement plans.

SEC Resources and Authority

- The legislation significantly increases the resources of the SEC by authorizing $776 million for FY 2003 to fully fund pay parity, update computer technology, and hire more staff. It also codifies Section 102(e) of the SEC Rules of Practice to authorize the SEC to censure or deny the right to practice before the SEC to professionals who have violated the securities laws, engaged in improper professional conduct, or in other ways lack qualifications.

The investor protection and accounting oversight legislation reported out of the Senate Banking Committee now goes to the full Senate for consideration where, as noted above, it may be packaged together with pension security and securities fraud litigation legislation. The legislation could be taken up before

Congress leaves at the beginning of August for the summer recess, but the Senate Floor agenda is with other important priorities.

The principal enemy of the investor protection and accounting oversight legislation now is time, as Congress wrestles in this election-shortened session to get through all 13 appropriations measures necessary to keep the Federal Government operating, defense authorization legislation, the Department of Homeland Security legislation, and a host of other priorities.

House Legislation

As previously reported, the full House of Representatives on April 24 passed the investor protection and accounting reform legislation drafted by House Financial Services Committee Chairman Michael Oxley (R-Ohio). The House legislation is known as the "Corporate and Auditing Accountability, Responsibility, and Transparency Act" (H.R. 3763). The legislation would make a number of changes in the regulation of the accounting profession as well as providing for enhanced corporate disclosure to investors. Critics have argued the legislation is tepid because it fails to provide for a strong oversight board for the accounting industry and fails to do enough to assure auditor independence.

On the accounting side, the measure would prohibit accounting firms from providing internal auditing and financial computer systems consulting services to their audit clients – though the lucrative tax consulting services could continue. A new five-member "public" regulatory board would be established to oversee the accounting profession. This new regulatory board would be "public" in the sense that three of the five members of the board would be comprised of persons not associated with the accounting profession and would operated under the "direct authority" of the Securities and Exchange Commission. (However, during markup the Committee adopted an amendment defining “not associated with the accounting industry” as not having worked in the accounting industry within the past two years.) Accountants and their firms would be subject to "certification" by this new board and would have statutory authority to impose penalties on accountants who violate securities laws or standards of ethics, competency, or independence.

On the corporate disclosure side, the measure would require that off-balance sheet transactions be "fully disclosed". Corporate insiders would be required to inform the SEC and the public within a 1-2 day period after they sell company stock, rather than waiting up to 40 days under current law. Public companies would be required to make public disclosure "on a rapid and essentially contemporaneous basis, of information concerning the issuer's financial health and operations." It also would be made unlawful for any person associated with the company to "interfere" with the auditing process. The SEC would be required to conduct regular and thorough audit reviews of the largest and most widely traded

companies. Finally, the legislation would require a number of studies, including stock analyst conflict of interest, corporate information disclosure, role of credit rating agencies, and corporate governance.

SEC Regulatory Efforts

In its continuing effort to reinject itself into the investor protection and accounting oversight debate, the SEC is expected to announce on June 20 a new "Public Accountability Board" which, operating under SEC supervision, would be given the mission to "set or oversee the establishment of professional audit, quality control, and ethics standards", according to a letter from SEC Chairman Harvey Pitt to President Bush. However, in lieu of setting such standards directly, the new board simply could adopt standards developed by a private industry standards group. The SEC proposal could be implemented on a regulatory basis, subject to being superceded by any legislation ultimately adopted by Congress on the subject.

The new board will have the power to undertake reviews of accounting firms and to discipline accounting firms and individuals, but would not have formal subpoena power. The board will have six "public members" and three members of the accounting profession. The board will be funded by accounting firms and by audited companies. Past versions of accounting oversight boards raised by SEC Chairman Pitt have been criticized as lacking independence from the accounting industry and strong enforcement powers.

In addition, Chairman Pitt's letter to the President indicates that the SEC will issue rules later this summer requiring all SEC-registered companies to have independent audit committees of the board that would bear "sole responsibility" for hiring and firing independent auditors and for approving in advance the provision of non-audit services to the company by the independent auditor.

These SEC actions come in the wake of other new rules announced by the SEC on June 12 that require a company's principal executive officer and principal financial officer to certify the contents of the company's quarterly and annual financial reports. The certification would be that: the officer has read the report (certainly a breathtaking start to reform), the report is true in all important respects to the officer's knowledge, and the report contains all information about the company of which the officer is aware and believes is "important to a reasonable investor". For this purpose, information would be deemed "important to a reasonable investor" if (i) there is a substantial likelihood that a reasonable investor would view the information as significantly altering the "total mix of information" in the report, and (ii) the report would be misleading to a reasonable investor if the information were omitted from the report.

In addition, the June 12 SEC rules would require companies to maintain procedures to provide "reasonable assurance" that the company is able to collect, process, and disclose all information that is required to be disclosed in the company's reports. Finally, the SEC required prompter disclosure on Form 8-K of extraordinary corporate events.

Corporate Governance Reforms by Listing Exchanges

Proposed NYSE Guidelines

The New York Stock Exchange's Corporate Accountability and Listing Standards Committee on June 6 proposed new standards and changes in corporate governance and disclosure practices of NYSE-listed companies. The NYSE Board of Directors must approve these proposed changes. Under a key proposed change, the boards of companies listed on the NYSE would be required to have a majority of independent directors, who would be given an expanded role in board decision making. There would be a two-year transition period for listed companies to meet this independent director requirement. Other aspects of the proposals, according to the NYSE's description, call for:

- Increasing the responsibilities of board audit committees;
- Mandating that shareholders vote on all equity-based compensation plans, including stock option plans;
- Requiring audit, nominating and compensation committees to consist solely of independent directors, with a requirement that the chair of the audit committee have accounting or financial management experience;
- Tightening the definition of an independent director, including a five-year cooling-off period for former employees;
- Mandating that director compensation represent the sole remuneration from the listed company for audit-committee members;
- Granting the audit committee sole authority to hire and fire auditors and to approve any significant non-audit work by the auditors;
- Requiring the CEO of NYSE-listed companies to attest to the accuracy, completeness and understandability of information provided to investors;
- Mandating that listed companies adopt and publish corporate governance guidelines and a code of business conduct and ethics;

- Establishing a Directors' Education Institute to assist directors in their responsibilities;

- Allowing the NYSE to impose additional penalties, including public reprimand letters, in addition to suspension and delisting;

- Requiring non-U.S. issuers to disclose how their practices differ from NYSE rules and procedures.

In addition, the NYSE Committee made various recommendations to Congress and the SEC:

- Establishing a new private-sector organization, funded separately from the accounting industry itself, to monitor and govern public accountants;

- Calling for the SEC to evaluate the impact of Regulation FD on earnings guidance and to consider reforms;

- Asking Congress to allocate additional resources to the SEC to increase the agency's monitoring and enforcement activities;

- Prohibiting relationships between auditors and their clients that would affect the fairness and objectivity of audits;

- Calling for Congress to establish a public/private panel to study the concentration of employee 401(k) holdings in company stock;

- Giving the SEC the authority to permanently bar officers and directors from holding office again after violating their duties to shareholders;

- Calling on the SEC to require companies to report complete GAAP-based financial information before any reference to "pro forma" or "adjusted" financial information;

- Calling for the SEC to exercise more active oversight of the FASB to improve the quality of GAAP and the speed of FASB actions;

- Asking the SEC to improve management's discussion and analysis disclosure on critical accounting alternatives and assumptions;

- Requiring the prompt disclosure of insider transactions.

New NASDAQ Rules

NASDQ announced on June 5 that its Board of Directors has approved a series of new corporate governance rules which, following a comment period, are expected to be implemented for NASDAQ companies later this summer. These new rules relate, according to NASDAQ's description, to:

- **Stock Option Plans**

  Requires shareholder approval for all plans in which officers and directors participate. Although existing exemptions for inducement grants to new executive officers and tax qualified, non-discriminatory plans such as Employee Stock Ownership Plans (ESOP) were retained, the new rule does not include the so-called "treasury share" exception that would permit a company to use certain repurchased shares to fund options to executive officers without prior shareholder approval.

- **Independent Directors**

  The definition will be extended to prohibit any payments, other than for board service, including political contributions, in excess of $60,000 and will extend to receipt of such payments by a family member of the director. Furthermore, a director will not be considered independent if the company makes payments to a charity where the director is an executive officer and such payments exceed the greater of $200,000 or five percent of either the company's or the charity's gross revenue.

- **Related Party Transactions**

  A company's audit committee or a comparable body of the board of directors must review and approve all related-party transactions.

- **Explicit Prohibition on Misrepresenting Information to Nasdaq**

  A material misrepresentation or omission by an issuer to Nasdaq may result in the company being delisted.

- **Requirement to Disclosure Audit Opinions with Going Concern Qualifications**

  A going concern qualification must be brought to the attention of investors and potential investors through a press release.

- **Disclosure of Material Information**

  The Nasdaq rule on disclosure of material information rule will be harmonized with SEC Reg FD to facilitate disclosure by issuers using Reg FD methods such as conference calls, press conferences and web casts, so long as the public is provided adequate notice (generally by press release) and granted access.

  As part of its process in developing these rule changes and other reforms, in May, Nasdaq hosted Corporate Governance Summits in San Jose, California, and New York City. Many senior executives of Nasdaq-listed companies attended and interacted with speakers from the investment community, investor advocates, the accounting profession, and the SEC. A report will be written and forwarded to the SEC, the Council, and the board for their consideration as they review corporate governance issues.

In addition, NASDAQ announced that its Listing and Hearing Review Council will review potential additional corporate governance reforms at the next Council's meeting to be held in San Francisco on June 26-28:

- A majority of independent directors on corporate boards;
- Compensation committees composed solely of independent directors;
- A cooling-off period during which former auditors would be precluded from serving on corporate audit committees;
- Expanding the scope of audit committee authority;
- Strengthening continuing education for directors;
- Increasing the use of corporate codes of conduct and compliance methods to support them; and
- Mandate non-U.S. companies to disclose if they have received waivers of corporate governance standards through a new SEC disclosure requirement.

Securities Fraud Litigation Legislation

As previously reported, on May 6, the Senate Judiciary Committee reported out to the full Senate S. 2010, the "Corporate and Criminal Fraud Accountability Act of 2002", drafted by Chairman Patrick Leahy (D-Vt.).

The legislation would supplement the current patchwork of technical securities law violations with a more general and less technical provision, comparable to bank fraud statutes. The legislation simply would make it a felony to "defraud any person in connection with any security of any issuer with a class of securities [registered under section 12 or required to file reports under section 15(d) of the Securities and Exchange Act]." The new securities fraud felony also would apply to any effort "to obtain, by false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any [such issuer]." The new felony would be punishable by up to 10 years in prison.

The sentencing guidelines would be made more stringent for fraud cases in which evidence was destroyed or fabricated, large numbers of investors were harmed, or where the harm to investors was particularly grave. The measure would make it a crime to destroy evidence in a federal investigation of a securities fraud case involving a publicly-traded company.

This legislation would extend the period of limitations for securities fraud cases brought by investors against public corporations to the earlier of five years after the date of the fraud or two years after the fraud was discovered (reduced from three years in the introduced legislation). The measure also would limit the ability of those who have committed securities fraud to use the shield of bankruptcy against investor suits. Finally, new "whistleblower" protections would be provided for employees of public companies in connection with disclosure of fraud to regulators.

This securities fraud litigation legislation is expected to be packaged together with the investor protection and accounting oversight legislation reported out of the Senate Banking Committee and some version of pension security legislation into a single omnibus "Enron" package of legislation.

Pension Security Legislation

House Legislation

As previously reported, on April 11, the House of Representatives passed the first piece of legislation responding to the Enron debacle by adopting a pension security package, H.R. 3762 (the "Pension Security Act of 2002"). This legislation melded together competing versions of the legislation produced by the House Ways and Means Committee, chaired by Rep. Bill Thomas (R-Bakersfield), and the Education and Workforce Committee, chaired by Rep. John Boehner (R-Ohio).

The key features of the House pension security legislation, according to the official description, are as follows:

Investment Education and Benefit Statement:

- The bill requires the plan administrator of a self-directed defined contribution plan to provide an annual notice to plan participants and beneficiaries of the value of investments allocated to their individual account, including their rights to diversify any assets held in employer securities. Defined benefit plans would have to provide a benefit statement at least one every 3 years to be a participant.

- The notice will also include an explanation of the importance of a diversified investment portfolio including a risk of holding substantial portions of a portfolio in any one security, such as employer securities.

- The Secretary of Treasury will issue guidance and model notices that include the value of investments, the rights of employees to diversify any employer securities and an explanation of the importance of a diversified investment portfolio. Initial guidance will be no later than January 1, 2003. The Secretary may also issue interim model guidance.

- Notice may be electronic if reasonably accessible to the recipient.

Blackout Notices:

- The bill requires a new notice 30 days prior to any suspension of participant and beneficiaries ability to direct or diversify assets. The notice must contain the reasons for the suspension, as well as a statement that the administrator has evaluated the reasonableness of the expected period, and a statement that the participant should evaluate the appropriateness of their current investment decisions in light of their inability to direct or diversify assets during the expected period of suspension.

- The bill requires that plan administrators shall determine prior to distributing notice that any suspension, limitation or restriction is reasonable.

- The bill clarifies that notice is required only for suspensions longer than three consecutive calendar days and provides for specific exceptions to the 30 day rule. In the event of a qualified domestic relations order, or a blackout period caused by a merger or acquisition, only those employees who are impacted by the event will receive the notice.

- The bill provides that the Secretary shall issue guidance and model notices that include the above factors and such other provisions the Secretary may specify. Initial guidance will be no later than January 1, 2003. The Secretary may issue interim model guidance.

- The bill clarifies that notice may be electronic if reasonably accessible to the recipient.

- The bill provides that the Secretary may provide for additional exceptions to the requirements that are in the interest of participants and beneficiaries.

Inapplicability of Relief from Fiduciary Liability During Suspension of Ability of Participants to Direct Investments

- The bill explains fiduciary duty during blackout period. It clarifies that fiduciaries are not liable for losses provided that fiduciaries satisfy the requirements of this title.

- Relevant considerations in determining the satisfaction of fiduciary duty are also added, such as the provision of the blackout notice, the fiduciary's consideration of the reasonableness of the period of suspension, and the fiduciary's actions solely in the interest of participants and beneficiaries.

Diversification:

- The bill ensures that all employee contributions to pension plans will be immediately diversifiable.

- The bill provides for a five year transition rule for the allowable diversification of employer securities held in individual account plans as of the date of enactment.

- The bill provides for the option of a rolling three-year diversification of employer securities. In this case employer securities may be diversified three years after the calendar quarter in which they were contributed.

- The bill in general exempts individual account plans that do not hold employer securities that are readily tradable on an established securities market.

Investment Advice:

- The bill includes the text of H.R. 2269, the Retirement Security Advice Act, which provides increased availability of investment advisors to assist plan participants in making good decisions about their retirement assets.

- Employees will also be able to use pre-tax dollars to obtain their own investment advice.

Parity for Employees During Blackouts:

- The bill amends Section 16 the Securities and Exchange Act of 1934 to prohibit company executives and insiders from purchasing or selling any employer securities while plan participants and beneficiaries are precluded from directing or diversifying their accounts during a "blackout" period.

We are continuing to coordinate with the informal working group of State and local government organizations, with CalPERS, and with the Governor's office in Washington in working with Congressional staff in the Senate – as the Finance Committee staff works to put together counterpart legislation—to clarify several technical aspects of these provisions.

Senate Legislation

With the Senate Health, Education, Labor, and Pensions Committee already having reported out its pension security package, the Senate continues to await action by the Senate Finance Committee, which has jurisdiction over the tax rules governing pension plans and shares jurisdiction over ERISA with the Senate Labor Committee.

a. Senate Labor Committee package

As previously reported, the Senate Health, Education, Labor, and Pensions Committee, chaired by Sen. Edward Kennedy (D-Mass.), adopted a controversial version of pension security legislation (S. 1992) on a sharply divided party line vote.

The Senate Labor Committee measure would permit continued use of employer stock matches and of company stock as an investment option, but not both. Employer requirements that plan assets be invested in employer stock would be barred.

Plan sponsors could designate independent investment advisors for participants, in accordance with certain guidelines. Pension benefit statements would be required on a quarterly basis.

The plan sponsor and plan administrator would have a new fiduciary duty under ERISA to provide each participant who exercise control over assets in his or her account with "all material investment information regarding investment of such assets to the extent that such information is generally required to be disclosed by the plan sponsor to investors in connection with an investment under the applicable securities laws."

The plan fiduciary could be sued under ERISA for breach of fiduciary duty. The fiduciary of an individual account plan having more than 100 participants would have to provide adequate insurance coverage for failure to comply with fiduciary duties. Liability for breach of fiduciary duty would be extended to other persons who participate in or conceal such breach.

Thirty days written notice would have to be provided in advance of any "lock-down", which could not continue for an unreasonable period of time.

Insider stock transactions would have to be disclosed promptly in electronic form.

Finally, in a significant and likely controversial change to ERISA, the Senate Labor Committee proposal requires that a single employer plan which an individual account plan covering more than 100 participants must be governed by a board of trustees, half of whom shall represent employer interests and half shall represent participant interests. In the case of collectively-bargained plans, the trustees representing employee interests are to be determined by election in which all participants may participate.

b. <u>Senate Finance Committee proposal</u>

The Senate Finance package is expected to cover many of the same areas as the House Ways and Means measure that was merged into H.R. 3762 that passed the House. The Finance Committee's package is still under development and is expected to be taken up by the Committee in July.

Senate Majority Leader Daschle then will face the challenge of melding together the controversial Senate Labor Committee package, which was adopted on a straight party-line vote, and the more moderate, likely bipartisan Finance Committee package.

Elk Hills Compensation

We are continuing our year-long effort to pursue the necessary Congressional appropriation of the fifth $36 million installment of Elk Hills compensation due for FY 2003, working with our House champion, House Ways and Means Committee Chairman Bill Thomas (R-Bakersfield), and our Senate champion, Sen. Dianne Feinstein (D-Ca.).

As previously reported, the entire 52 Member California House delegation has sent a letter to the House appropriators in strong support of the appropriation for the fifth installment of Elk Hills compensation.

A request for the Elk Hills appropriation from all 52 California House Members having gone into the House appropriations leadership, the next step in the process is Committee mark-up of the Interior Appropriations legislation for FY 2003 by the House Interior Appropriations Subcommittee, chaired by Rep. Joe Skeen (R-N.M.). That mark-up is not expected until July. We continue to work with Rep. Thomas and his staff to follow up on the Elk Hills appropriations request.

On the Senate side, Sen. Dianne Feinstein (D-Ca.) sits on the Senate Interior Appropriations Subcommittee which will consider the Elk Hills issue. We have worked well with her staff on this issue over the years and will continue to coordinate with her office.

Medicare Prescription Drug Legislation

Ignoring the ballooning Federal budget deficit in this election year, Congressional Republicans and Democrats each rolled out on June 17 competing versions of a new Medicare prescription drug benefit. The House Republicans' proposal would cost a total of $350 billion over 10 years, while the Senate Democrats' proposal would cost a total of $500 million over six years and as much as $800 million over ten years.

As adopted by the House Ways and Means Committee on June 18, the House GOP proposal would provide for a stepped approach to the new prescription drug benefit that would be offered through private insurance or a managed care plan. After a $250 annual deductible, 80 percent of the first $1,000 of drug costs would be paid by the new benefit, followed by 50 percent of the next $1,000. The senior would be responsible for the full amount of the next $2,000 of drug costs. After a maximum out-of-pocket cap of $3,800 of annual drug expenses incurred by the senior (that are not otherwise reimbursed under the new program), the benefit would cover the full amount of any additional drug expenses. The monthly premium would be $34.

The Senate Democratic plan would take a somewhat different approach. Rather than focusing on a senior's overall prescription drug spending for the year, the plan would mandate a system of co-payments of $10 for each generic drug purchase and $40 for a brand-name drug still under patent. The benefit would be part of Medicare itself, rather than being run through private vendors as under the House GOP proposal. The Senate Democratic plan would cap annual out-of-pocket drug expenses at $4,000. The monthly premium would be $25.

John S. Stanton

Washington, D.C.
June 19, 2002

STATUS OF FEDERAL LEGISLATION AFFECTING CalSTRS

CORPORATE GOVERNANCE

BILL/ SPONSOR	STATUS (6/21/02)	SUMMARY
S. 2460 (Levin)	Senate Committee on Banking, Housing, and Urban Affairs	A bill to guarantee persons who invest in publicly held companies accurate information about the financial condition of such companies so they can make fully informed investment decisions, to increase the independence of the Financial Accounting Standards Board, and for other purposes.

INVESTOR PROTECTION AND ACCOUNTING OVERSIGHT

BILL/ SPONSOR	STATUS (6/21/02)	SUMMARY
*S. unnumbered (Sarbanes)	Approved by Senate Committee on Banking, Housing, and Urban Affairs	Would establish a stronger accounting oversight board than under the House legislation, seeks to promote greater independence of outside auditors, provides for reforms in corporate governance and financial disclosure.
* H.R. 3763 (Oxley)	Senate Committee on Banking, Housing, and Urban Affairs	To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.
S. 2004 (Dodd)	Senate Committee on Banking, Housing, and Urban Affairs	A bill to improve quality and transparency in financial reporting and independent audits and accounting services, to designate an Independent Public Accounting Board, to enhance the standard setting process for accounting practices, to improve Securities and Exchange Commission resources and oversight, and for other purposes.

SECURITIES FRAUD LITIGATION

BILL/ SPONSOR	STATUS (6/21/02)	SUMMARY
* S. 2010 (Leahy)	Senate Committee on the Judiciary Subcommittee on Crime and Drugs	To provide for criminal prosecution of persons who alter or destroy evidence in certain Federal investigations or defraud investors of publicly traded securities, to disallow debts incurred in violation of securities fraud laws from being discharged in bankruptcy, to protect whistleblowers against retaliation by their employers, and for other purposes.

* Key legislation for the issue

STATUS OF FEDERAL LEGISLATION AFFECTING CalSTRS

PENSION SECURITY

BILL/ SPONSOR	STATUS (6/21/02)	SUMMARY
H.R. 2269 (Boehner)	Senate Committee on Finance	Would amend title I of the ERISA of 1974 and the IRC of 1986 to promote the provision of retirement investment advice to workers managing their retirement income assets.
H.R. 3657 (Miller)	House Subcommittee on Employer-Employee Relations	Would amend the ERISA of 1974 to provide for improved disclosure, diversification, account access, and accountability under individual account plans.
H.R. 3669 (Portman / Cardin)	Committee of the Whole House	Would amend the IRC of 1986 to empower employees to control their retirement savings accounts through new diversification rights, new disclosure requirements, and new tax incentives for retirement education.
*H.R. 3762 (Boehner-Thomas)	Senate Committee on Health, Education, Labor, and Pensions	Amend title I of the ERISA of 1974 and the IRC of 1986 to provide additional protections to participants and beneficiaries in individual account plans from excessive investment in employer securities and to promote the provision of retirement investment advice to workers managing their retirement income assets, and to amend the Securities Exchange Act of 1934 to prohibit insider trades during any suspension of the ability to plan participants or beneficiaries to direct investment away from equity securities of the plan sponsor.
S. 1919 (Wellstone)	Senate Committee on Health, Education, Labor, and Pensions	Would amend the Employee Retirement Income Security Act of 1974 to provide for improved disclosure, diversification, account access, and accountability under individual account plans.
S. 1971 (Grassley)	Senate Committee on Finance	Amends the IRC of 1986 and the ERISA of 1974 to protect the retirement security of American workers by ensuring that pension assets are adequately diversified and by providing workers with adequate access to, and information about, their pension plans, and for other purposes.
* S. 1992 (Kennedy)	Senate Committee on Health, Education, Labor, and Pensions	Amends the ERISA of 1974 to improved diversification of plan assets for participants in individual account plans, to improved disclosure, account access, and accountability under individual account plans, and for other purposes.
S. 2190 (Kerry-Snowe)	Senate Committee on Finance	A bill to amend the Internal Revenue Code of 1986 and the ERISA of 1974 to provide employees with greater control over assets in their pension accounts by providing them with better information about investment of the assets, new diversification rights, and new limitations on pension plan blackouts, and for other purposes.

* Key legislation for the issue

STATUS OF FEDERAL LEGISLATION AFFECTING CalSTRS

CONFIDENTIALITY OF SOCIAL SECURITY NUMBER PROVISIONS

BILL/ SPONSOR	STATUS (6/21/02)	SUMMARY
H.R. 220 (Paul)	House Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations	Would amend title II of the Social Security Act and the Internal Revenue Code of 1986 to protect the integrity and confidentiality of Social Security account numbers issued under such title, would prohibit the establishment in the Federal Government of any uniform national identifying number, and would prohibit federal agencies from imposing standards for identification of individuals on other agencies or persons.
H.R. 2036 (Shaw / Clay)	House Subcommittee on Financial Institutions and Consumer Credit	Would amend the Social Security Act to enhance privacy protections for individuals, to prevent fraudulent misuse of the Social Security account number, and for other purposes.
S. 324 (Shelby)	Senate Committee on Banking, Housing, and Urban Affairs	A bill to amend the Gramm-Leach-Bliley Act, to prohibit the sale and purchase of the social security number of an individual by financial institutions, to include social security numbers in the definition of nonpublic personal information, and for other purposes.
S. 451 (Nelson)	Senate Committee on Finance	A bill to establish civil and criminal penalties for the sale or purchase of a social security number.
S. 848 (Feinstein)	Senate Committee on Finance	A bill to amend Title 18, United States Code, to limit the misuse of Social Security numbers, to establish criminal penalties for such misuse, and for other purposes.
S. 1014 (Bunning)	Senate Committee on Finance	To amend the Social Security Act to enhance privacy protections for individuals, to prevent fraudulent misuse of the Social Security account number, and for other purposes.

* Key legislation for the issue

STATUS OF FEDERAL LEGISLATION AFFECTING CalSTRS

OFFSET REDUCTION PROVISIONS

BILL/ SPONSOR	STATUS (6/21/02)	SUMMARY
H.R. 664 (Jefferson)	House Subcommittee on Social Security	Would amend Title II of the Social Security Act to provide that the reductions in Social Security benefits which are required in the case of spouses and surviving spouses who are also receiving certain government pensions shall be equal to the amount by which the total amount of the combined monthly benefit (before reduction) and monthly pension exceeds $1,200.
H.R. 848 (Sandlin)	House Subcommittee on Social Security	Would amend Title II of the Social Security Act to eliminate the provision that reduces primary insurance amounts for individuals receiving pensions from non-covered employment.
H.R. 1073 (Frank)	House Subcommittee on Social Security	Would amend title II of the Social Security Act to restrict the application of the Windfall Elimination Provision to individuals whose combined monthly income from benefits under such title and other monthly periodic payments exceed $2,000 and to provide for a graduated implementation of such provision on amounts above $2,000.
H.R. 2462 (Brady)	House Committee on Ways and Means	Would amend the Internal Revenue Code of 1986 to provide an exclusion from gross income for that portion of a governmental pension received by an individual which does not exceed the maximum benefits payable under Title II of the Social Security Act which could have been excluded from income for the taxable year.
H.R. 2638 (McKeon)	House Subcommittee on Social Security	Would amend Title II of the Social Security Act to repeal the Government Pension Offset, and Windfall Elimination Provision.
H.R. 3497 (Shaw)	House Committee on Ways and Means	Would amend the Social Security Act and the Internal Revenue Code of 1986 to preserve and strengthen the Social Security program through the creation of personal Social Security guarantee accounts ensuring full benefits for all workers and their families, restoring long-term Social Security solvency, to make certain benefit improvements, and for other purposes.
S. 611 (Mikulski)	Senate Committee on Finance	Would amend title II of the Social Security Act to provide that the reductions in Social Security benefits which are required in the case of spouses and surviving spouses who are also receiving certain Government pensions shall be equal to the amount by which two-thirds of the total amount of the combined monthly benefit (before reduction) and monthly pension exceeds $1,200, adjusted for inflation.
S. 1523 (Feinstein)	Senate Committee on Finance	Would amend Title II of the Social Security Act to repeal the Government Pension Offset, and Windfall Elimination Provision.

* Key legislation for the issue

STATUS OF FEDERAL LEGISLATION AFFECTING CalSTRS

INDIVIDUAL ACCOUNT PROVISIONS

BILL/ SPONSOR	STATUS (6/21/02)	SUMMARY
H.R. 3535 (DeMint)	House Committee on Ways and Means	Would amend the Social Security Act and the Internal Revenue Code of 1986 to preserve and strengthen the Social Security program through the creation of individual Social Security accounts ensuring full benefits for all workers and their families, giving Americans ownership of their retirement, restoring long-term Social Security solvency, and for other purposes.

ADMINISTRATIVE PROVISIONS

BILL/ SPONSOR	STATUS (6/21/02)	SUMMARY
H.C.R. 120 (Green)	House Subcommittee on Social Security	Expressing the sense of the Congress that Social Security reform measures should not force State and local government employees into Social Security coverage.
H.C.R. 229 (Graves)	House Subcommittee on Social Security	Expresses the sense of the Congress that any reform of the Social Security program not include mandatory coverage of State and local employees.
H.R. 4069 (Shaw-Matsui)	Senate Finance Committee	To amend title II of the Social Security Act to provide for miscellaneous enhancements in Social Security benefits, and for other purposes.
S. 2533 (Smith)	Senate Finance Committee	To amend title II of the Social Security Act to provide for miscellaneous enhancements in Social Security benefits, and for other purposes.

ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

BILL/ SPONSOR	STATUS (6/21/02)	SUMMARY
H.R. 4800 (Camp)	Committee of the Whole Senate	To repeal the sunset of the Economic Growth and Tax Relief Reconciliation Act of 2001 with respect to the expansion of the adoption credit and adoption assistance programs.
H.R. 4823 (Shaw)	Committee of the Whole Senate	To repeal the sunset of the Economic Growth and Tax Relief Reconciliation Act of 2001 with respect to the exclusion from Federal income tax for restitution received by victims of the Nazi Regime.
H.R. 4931 (Portman)	Passed in House	To provide that the pension and individual retirement arrangement provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 shall be permanent.

* Key legislation for the issue